

Internal Revenue Service

Department of the Treasury

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Date:

December 15, 2008

LEGEND:

Taxpayer =

State A =

LLC1 =

State B =

Corporation =

Trust =

LLC2 =

Individual A =

x =

Date 1 =

Buyer =

\$c =

Year 1 =

\$d =

e =

\$f =

\$g =

Dear :

This is in reply to a letter dated June 23, 2008, submitted by your authorized representative, requesting a ruling under § 453 of the Internal Revenue Code and § 15A.453-1(c)(7)(ii) of the Temporary Income Tax Regulations. Section 15A.453-1(c)(7)(ii) provides for use of an alternative method of basis recovery in circumstances involving contingent payment installment sales of property.

FACTS:

Taxpayer is a State A limited liability company that is treated as a partnership for federal income tax purposes. Taxpayer was formed by two members who collectively own 100 percent of Taxpayer. LLC1 is a State B limited liability company that is treated as a partnership for federal income tax purposes, and owns 75 percent of Taxpayer. LLC1 is owned by Corporation, Trust and LLC2. Individual A owns the remaining 25 percent interest of Taxpayer. Taxpayer uses the accrual method of accounting for federal income tax purposes and files its return on a calendar year basis. Taxpayer designed and manufactured x.

On Date 1, Buyer purchased substantially all the assets of Taxpayer pursuant to an Asset Purchase Agreement (Purchase Agreement). Under the terms of the Purchase Agreement, the Buyer agreed to (1) pay Taxpayer a cash purchase price, (2) assume certain liabilities of Taxpayer, and (3) pay Taxpayer a contingent purchase price.

The contingent purchase price component consists of four contingent earn-out payments over four tax years to be determined by a percentage of business revenue as defined in the Purchase Agreement. Specifically, the first contingent payment is based on a specified percentage of business revenue exceeding a threshold amount plus a specified percentage of business revenue in excess of a second threshold amount. Contingent payments two, three and four are based on a computation allowing for the lesser of a specified percentage of current year business revenue exceeding a threshold amount or a specified percentage of aggregate business revenue earned over the preceding years of the Purchase Agreement exceeding a threshold amount. Thus, the exact amount to be received by Taxpayer under the earn-out provisions is contingent on business revenue.

Initially, Taxpayer computed a total maximum selling price of \$c for its Year 1 federal income tax return, which included a maximum earn-out amount of \$d. Taxpayer based its estimate of the maximum earn-out payments to be received during the term of the installment obligation on historical data and earning trends. Taxpayer submitted its private letter ruling request before the date, including extensions, that its return for Year 1 was due.

RULING REQUESTED:

Taxpayer submits that the normal basis recovery rules of § 15A.453-1(c)(2), (3) and (4) will substantially and inappropriately defer recovery of basis and will result in a substantial distortion of Taxpayer's income. Accordingly, Taxpayer requests a ruling that it be permitted to use an alternative method of basis recovery, as provided under § 15A.453-1(c)(7)(ii). Taxpayer proposes to allocate the same ratio of basis to each installment payment as that installment payment bears to the estimated amount of aggregate payments to be received by Taxpayer during the four-year term of the installment obligation.

LAW AND ANALYSIS:

Section 453(a) of the Code provides as a general rule that, except as otherwise provided in that section, income from an installment sale shall be taken into account under the installment method for federal income tax purposes.

Section 453(b)(1) of the Code defines the term “installment sale” as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453(c) of the Code defines “installment method” as a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

Section 453(j)(2) of the Code provides that the Secretary of the Treasury shall prescribe regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot readily be ascertained.

Section 15A.453-1(c)(1) of the regulations defines the term “contingent payment sale” as a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which the sale or other disposition occurs. The term “contingent payment sale” does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property which is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions, regardless of the existence of a stated maximum selling price or fixed payment term.

Section 15A.453-1(c)(1) further provides rules for allocating a taxpayer's basis to payments received and to be received in a contingent payment sale. The rules distinguish between contingent payment sales for which a maximum selling price is determinable, sales for which a maximum selling price is not determinable but the time over which payments will be received is determinable, and sales for which neither a maximum selling price nor a definite payment term is determinable.

Section 15A.453-1(c)(3)(i) provides that when a stated maximum selling price cannot be determined as of the close of the taxable year in which a sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sales price agreement is fixed, the taxpayer's basis (inclusive of selling

expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.

Section 15A.453-1(c)(7)(ii) provides that a taxpayer may use an alternative method of basis recovery if the taxpayer is able to demonstrate, prior to the due date of the return including extensions for the taxable year in which the first payment is received, that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis. To demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis, the taxpayer must show (A) that the alternative method is a reasonable method of ratably recovering basis, and (B) that, under that method, it is reasonable to conclude that over time the taxpayer likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise applicable normal basis recovery rule. The taxpayer must receive a ruling from the Internal Revenue Service before using an alternative method of basis recovery.

In addition, § 15A.453-1(c)(7)(ii) provides guidelines as to what type of data is acceptable in demonstrating that application of the normal basis recovery rule would substantially and inappropriately defer recovery of the taxpayer's basis. The taxpayer in appropriate circumstances may rely upon contemporaneous or immediate past relevant sales, profits, or other factual data that are subject to verification. The taxpayer ordinarily is not permitted to rely upon projections of future productivity, receipts, profits, or the like. However, in special circumstances, a reasonable projection may be acceptable if the projection is based upon a specific event that already has occurred.

Taxpayer has represented that it is reasonable to assume an overall decline in revenue throughout the four-year installment period due to increased competition in the marketplace and the overall decline in the current economic environment. Taxpayer has demonstrated, based on contemporaneous business revenue estimates, that it expects to receive only about e percent of the maximum earn-out payment it originally projected. Taxpayer proposes to ratably recover basis over the four-year installment period and to use \$f as the total maximum selling price, which includes a maximum earn-out amount of \$g. Under this proposed method, Taxpayer will recover basis at a rate at least twice as fast as under the normal basis recovery rule.

CONCLUSION:

Based on the information submitted and the representations made, we conclude that application of the normal basis recovery rule of § 15A.453-1(c)(3) would substantially and inappropriately defer recovery of Taxpayer's basis in the property sold and that the use of the proposed alternative method of basis recovery will result in basis recovery at a rate at least twice as fast as the rate at which basis would be recovered under the normal basis recovery rule. The proposed alternative method of basis recovery

represents a reasonable method of basis recovery. Accordingly, the Taxpayer's use of the proposed alternative method of basis recovery is approved.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)

cc: